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I. INTRODUCTION

The road Western Europe took from the end of World War II to its current state has been one with lots of steep and sometimes blind curves, with harsh speed limits and frequent detours. But still it has been one that attracted more and more traffic. After a successful period of shaping a customs union and a free trade area following the Treaty of Rome (1957), Europe became infected with Eurosclerosis in the seventies due to an increased intensity of national regulation especially in the labor market. The constructionist approach to harmonization from above slowed down the speed of integration almost to a halt. Only the change of two fundamental rules revitalized the European integration process, namely the introduction of majority voting in the EC Council and the mutual recognition of national regulations brought about by the 1979 ruling of the European Court. With the Single European Act and the launch of the Internal Market program Europhoria blossomed out, finally leading to the Maastricht Treaty aimed at being the masterpiece of European integration. Only very recently, the Danish "No" and the unconvincing approval by the French voters cooled off hopes for a United States of Europe, signaling that European integration is at the crossroads once again.

Analyzing what is at the roots of the weak public support for the Maastricht Treaty there seems to be a deep mistrust in the member countries of the centralization of political and economic decisions at Brussels. While the Single European Act and Project '92 freed the EC of its bureaucratic chains by allowing for more flexibility in the integration process, the Maastricht Treaty is sending out mixed signals at best on how integration will be pursued in the 1990's. The introduction of the subsidiarity principle and the creation of a monetary union are examples of the two polar ways by which integration can be brought about. Subsidiarity allows subnational - or for that matter national - governments to take action in all areas that (a) do not fall within the exclusive competence of the Community and (b) where the Community cannot achieve significantly better outcomes than the nation-states. This goes along the lines of institutional competition. On the other hand, the creation of a single European currency looks like yet another showcase of centralized ex-ante harmonization. This paper analyzes whether the competition of national governments and national regulations is a superior way of achieving economic and political integration in the EC compared to the harmonization approach. It examines what is needed to make institutional competition work in practice and what the problems of market oriented integration are.

II. COMPETING GOVERNMENTS

The notion of competing governments and jurisdictions was introduced by Tiebout (1956) and has been a popular idea ever since. The core of the theory is that voters can vote with their feet and that factors of production can move to other places as well. With respect to production, competition among governments means that the immobile factors of production (Siebert 1969) compete for those factors that are internationally mobile by providing favorable conditions for production (Giersch 1989). The availability of immobile factors is understood as a composite commodity made up of various aspects such as an ample supply of land or labor and the quality of the work force. A variety of location factors is provided or influenced by governments. We call these factors institutional arrangements or regulations which may comprise laws, market regulations, economic policies, in short everything that is under the control of governments and can possibly influence the location decisions of mobile factors. Various authors put emphasis on different locational factors that supposedly attract mobile factors. Razin, Sadka (1991) analyze capital income taxation, Keen (1990) corporate taxation, and S. Sinn (1990) infrastructure. Oates, Schwab (1988), Siebert (1989a,b), and Long, Siebert (1991) examine institutional competition and environmental policy, Soltwedel (1987) regional policy and Verbon (1990) social security.

Institutional competition can be illustrated best by thinking of a market for institutional arrangements. National governments provide regulations in order to attract mobile factors. The inflow of capital and firms is needed to create new and better jobs and to raise the level of income so that voters reelect the incumbent governments. Institutional competition can work through two channels. Education may serve as an example. A government introduces a new system of vocational training and pumps additional money into the university system thereby creating a better educated, more able work force. Foreign firms may find the pool of qualified labor an attractive asset of the location and decide to move there. The relocation creates additional jobs and income and generates higher tax revenues that can be used to improve on the quality of transportation infrastructure. This, in turn, makes the location more attractive for firms. On the contrary, governments of countries that face an outflow of capital and the emigration of firms are forced to improve the quality of their domestic regulations. Thus, an incentive for thriving to invent ever better institutional arrangements is included. In addition to direct government action, institutional arrangements that have been successfully implemented in one country may serve as models for other countries. The independence of the German Bundesbank which has fought off inflation fairly successfully for more than three decades is a case in point. Slowly, central banks in other countries are partially being freed from government intervention. The same holds true for many more national regulations as diverse as the deregulation of financial markets that started in London and is now spreading across Europe, the privatization of state-owned firms, now even popular in Italy, and the point system for traffic offences in Great Britain and Germany, recently introduced in France.

The alternative to institutional competition is ex-ante harmonization: negotiators from all member countries agree on a set of rules that is going to become European law, replacing the respective national laws. A strenuous bargaining process is needed, and the seventies have shown that an ex-ante harmonization is impractical. The European integration process came to a standstill. Institutional competition, on the contrary, is an open-ended process (Siebert 1991), the results of which "are in their nature unpredictable" (Hayek 1984, p. 258). Whenever governments recognize that domestic regulations are too inefficient for citizens or companies, they face an incentive to repair or set up an entirely new system which may or may not copy successful solutions in other countries. This makes integration flexible and more acceptable especially for small member countries. It allows countries to take measures according to their individual preferences. It is hard to see why there have to be identical tax and environmental policies, one specific pension scheme or even worse, equalization of wages due to the so called social dimension of the Internal Market. Given the diversity of national political systems and economies in Europe, institutional competition allows governments to react individually to changes in their respective environments, trying out new solutions to new problems. This minimizes the cost of failure through using the market for regulations as an exploratory device for finding the best institutional arrangements (Hayek 1968).

The essential prerequisite for institutional competition to work is mobility of residents as economic agents (and as voters) and of factors of production, either labor or capital. Otherwise arbitrage between different national settings cannot take place. With respect to capital mobility this precondition seems to be fulfilled in Europe (Frankel 1991). All EC members have abolished capital controls with the minor exceptions of Portugal and Ireland which have promised to follow suit. Physical capital is also free to flow where investment opportunities are most profitable, though one has to bear in mind that capital once put in place is often immobile from then on and can only be relocated through depreciation. The same holds true for technology that is embodied in capital. Blueprints seem to be mobile to some extent depending on the patent system and property rights defining the conditions for international transferability of knowledge. In addition, consumers are mobile in that they can choose between national goods markets in the EC's many border regions and by buying through mail-order companies. Labor mobility, on the other hand, is still fairly low although there are not too many legal impediments to migration. It seems that people identify with their regions and that Europe is still diverse enough to make country specific human capital obsolete when crossing borders. In Europe's many border regions, however, labor mobility has already reached significant levels. Along the French-German border many French workers are employed in Germany while many Germans have settled in France holding on to their jobs in Germany. If this development spreads across Europe the effectiveness of institutional competition will increase further.

III. EUROPEAN INTEGRATION THROUGH INSTITUTIONAL COMPETITION

The famous 1979 ruling of the European Court made the country-of-origin principle omnipresent in the EC's goods markets. Barriers to market entry such as the German purity law for beer dating back to 1517 and the Italian noodle regulations, were no longer binding for foreign suppliers although it is left to the individual firm to stick to the old procedures as a mark of quality. Institutional competition in the form of the country-of-origin principle has put national regulations for products on trial, with the consumers being the jury. Now that the Internal Market program has almost been completed, the scope of the country-of-origin principle could, however, be expanded further because a wide range of products has been excluded so far, and the respective markets are still segmented. Transportation, telecommunications, the insurance business, banking, the airline industry, and utilities are major sectors that are far from being one European market. Institutional competition could dismantle the remaining national market segmentations, allowing, for example, Dutch carriers to offer service from Paris to Brussels or German drivers to insure their cars with British insurance companies. The first slow steps have been taken in the right direction. The Second Banking Directive allows banks to open up branches everywhere in Europe once they have obtained a banking license in their respective home countries. The supervising authority will be that of the domestic country with the foreign authority only supervising liquidity and the protection against risks in securities operations. Also, some parts of the insurance business have been europeanized, but important product lines such as car insurance are still excluded. Even the deregulation of the European airline industry is just now starting to make progress. The fact, however, that most European airlines are still owned by the government and treated as national flag (and pride) carriers makes delays in the implementation of the deregulation program more than a remote possibility.

Policymakers are under constant pressure from national interest groups to protect their specific interests. Olson (1965) argued that lobbies are all the better organized and more influential the higher expected payoffs are and the more evenly the costs can be spread on a large number of those financing the payoffs. If European integration were pursued through direct harmonization, the power of well organized interest groups to influence the decisions at the bargaining table in Brussels would grow since payoffs would increase while the costs could be spread among even more citizens. This would give rise to a Europe of minimum consensus or of widespread protectionism. Agricultural policy is a case in point. With institutional competition rent-seekers will be less influential because even if a favorable institutional arrangement could be pushed through in one country the other countries are not forced to follow: an anonymous market process evaporates the power of national interest groups (Siebert 1991). In addition, market based integration requires less bureaucracy in Brussels, not to mention the costs that can be avoided by not having negotiators of twelve countries sitting at the table in Brussels discussing the details of yet another product norm.

The strength of institutional competition partly derives from the observation that politicians and governments are of the Leviathan-type, i.e. their actions are primarily aimed at maximizing their own utility (income, power, prestige etc.) instead of increasing general welfare. The reason why this type of administrative failure occurs is that the voters' power to control governments is marginal since it can be exercised only every four or five years. In addition, bureaucrats more or less completely withdraw from public scrutiny. Institutional competition can act as another check. It works in that consumers, investors, firms, and workers have an additional way of voting - voting with one's feet or purse, the so called exit option (Hirschman 1970). This mechanism forces governments to work more efficiently and on behalf of their voters. It is a device to tame the Leviathan (Brennan, Buchanan 1980, S. Sinn 1990).

It is not hard to foresee that mobile factors will react more sensitively to the effective burdens of regulations in general and taxation in particular in a world where they can easily move abroad. The consequences will be twofold. Since firms will not long tolerate high corporate income taxes governments have to offer something in exchange. Institutional competition will move the taxation of mobile factors towards benefit taxation, where the user and the payer of a good are identical, approaching the concept of fiscal equivalence (Olson 1969). The second consequence will be that financing redistribution in favor of immobile factors through taxing mobile ones will only be feasible to the extent that transactions and mobility costs prevent the mobile factors from emigrating. Especially those countries will have to rethink their welfare systems that heavily depend on corporations for financing welfare programs such as France, which gets more than 40 percent of its welfare expenditures financed by corporations (Weber, Leienbach, Dohle 1991).

IV. INSTITUTIONAL COMPETITION IN PRATICE

Companies often claim that diverging institutional arrangements (regarding education, health care, social security, taxation, environmental protection etc.) produce different costs and therefore distort competition between firms residing in different countries. They demand, therefore, that regulations be harmonized, envisaging a level playing-field. For instance, legislation protecting the environment differs substantially within the Community and firms that have to obey stiff environmental laws face a cost disadvantage. The theoretical counterargument is that stiffer environmental laws simply reflect the higher ranking that good environment quality enjoys in a country's preference set. If preferences and endowments vary so should the specialization of an economy - familiar advice from standard trade theory. As a practical matter it can be observed that the cost disadvantages originating from higher environmental standards are in most cases only marginal to the overall costs firms incur (Dean 1992). Tobey (1990) found no empirical support for the hypothesis that the introduction of stringent environmental control measures changed trade patterns significantly. In the long run, the need to obey strict laws protecting the environment may even give firms a leading edge in the production of devices for environmental protection. The country as a whole may gain a comparative advantage in the development and production of such goods.

It is argued that in some areas institutional competition is no longer necessary because important factors that can distort competition in goods markets have already been or are currently being harmonized. Directives on working conditions define minimum standards for health protection of workers, technical standards such as those negotiated under the auspices of the European Committee for Standardization (CEN) reduce transaction costs in international trade. The administration of the VAT in the borderless market is designed to keep the destination principle alive, and minimum rates for excise taxes are agreed upon. In some cases like establishing European technical standards harmonization makes sense, in other areas such as VAT it does not. Here, a rather complicated interim solution had to be implemented shifting the previous tax border inside the individual firm. Institutional competition may still help to find a new and more efficient solution in the future. For instance, direct consumer imports and mail-order firms are effective devices for enforcing institutional competition. To bring about airtight harmonization with respect to indirect taxation, countries that rely on excise taxes only marginally had to be forced to raise their tax rates (e.g. Belgium and the Netherlands with only about seven percent of total tax revenues). Through this, firms in high tax countries were protected from losing customers. Low tax countries found it comfortable to increase tax rates since this bestows additional tax revenues on them. The lid that institutional competition is intended to put on governments ability to collect tax revenues has been lifted.

Another argument put forward against institutional competition is that it will lead to levels of regulations that are below the optimum. This is referred to as the problem of zero-regulation. An example that has been frequently cited is tax competition (for an optimistic view see McLure 1986, for a more negative one see H.-W. Sinn 1990). A country may attract foreign firms by reducing its corporate income tax. Since other countries face emigration of firms they will follow suit in reducing their own rates destroying the advantages of the other country which might in turn start the next round of tax cuts. Empirical support is easily available: the EC's average corporate income tax rate dropped from 46.75 percent in 1984 to as little as 39.23 percent in 1991. Income and capital income tax rates exhibit a similar pattern. Does that mean institutional competition is a bad thing because it leaves countries without tax revenues and without proper regulations in general? The answer - again - is no. Razin, Sadka (1989) show that even if countries engage in tax competition the harmonization of tax rates would not yield any welfare gains at all. Moreover, looking only at the revenue side of taxes and regulations keeps one from seeing the other side of the coin. Cutting tax rates may generate higher tax revenues which conincides to the simultaneous decline in corporate tax rates and (modest) absolute increase in tax revenues in some countries. If cutting tax rates, however, decreases tax revenues governments' ability to finance public spending will shrink. If public spending exhibits diminishing marginal returns, cutting these expenditures will lead to increasing welfare losses whereas the benefits of lower taxes will decrease. At some point, the opportunity costs of cutting taxes will offset the benefits of doing so and rational governments will stop lowering the tax burden (Siebert 1990). In general, the net welfare effect of a marginal change in the level of a regulation (or a tax rate) should be zero, marginal costs and benefits should be equal.

S. Sinn (1990) proposes that one way of attracting foreign capital and firms is to use tax revenues to provide excellent infrastructure to stimulate private sector productivity, i.e. to make private investment more profitable. An extensive road and railroad system, airports providing connection to many destinations, and good and cheap telecommunications may make a location attractive. Improved infrastructure also lowers transport costs which are a natural basis for market segmentations. Empirical evidence on that matter, however, is inconclusive at best. Aschauer (1989) showed for the U.S. that publicly provided infrastructure had a major positive impact on private capital productivity. Ford, Poret (1991), on the contrary, could confirm the Aschauer findings only for U.S. post-war data but not for the other OECD countries and not for longer periods of time. The weak econometric support for the theoretically appealing hypothesis may be due to the fact that infrastructure and thus transport cost is just one locational factor among many others. Nevertheless, Krugman (1991) argues that transport costs will be an important factor in the structural adjustment process following the completion of the Internal Market. Depending on transport costs, the size of economies of scale, and the share of footloose industries, different location patterns may emerge. If transport costs fell significantly, comparative (production) cost advantages could finally come to play their roles. Firms would locate some of their production activities to the periphery, especially for labor-intensive goods, thereby preventing a de-industrialization of the periphery, a "Mezzogiornification" (Krugman 1991, p. 80). In a Europe with institutional competition, closing firms and outflowing capital provide strong incentives for governments to improve the infrastructure. In this line of reasoning, institutional competition can be a mechanism for achieving efficiency in production and a means of regional policy in that it counteracts the peripherization of regions.

In border regions, some people argue, institutional competition cannot work because consumers can arbitrage differences in regulations without having to relocate. That means they can take advantage of regulations abroad without having to pay for it. The small border between Luxembourg and Germany is an example. Every day thousands of Germans cross the border to get gas in Luxembourg where the tax on petroleum is just a fraction of the German rate. Thus, Germany loses tax revenues. However, if there are problems in border regions then these are rather problems for the small countries. To the German Minister of Finance it does not really matter whether a handful of Germans avoid the tax on gas, but what if the tax rates were set the other way round and virtually all Luxembourgians would buy their gas in Germany? Although the government of Luxembourg would understandably regret to do so, it must lower its tax rate. This is just the kind of arbitrage that limits governments ability to raise ever bigger tax revenues. Border regions are the places where institutional competition works best.

This example, however, indicates that there may be some scope for strategic behavior on the side of the governments. Since the number of participants in the market for regulations is small and the good traded is not homogeneous, governments of big countries might exert some monopoly power. Take national product norms as an example. Historically, governments have imposed a wide range of obligations on producers on the grounds of consumer protection and public saftey. Through mutual recognition of product norms the different levels of obligations (and associated costs) are increasingly seen as distorting the movement of goods within the EC. This is particularly obvious when taking into account that governments frequently used product norms to protect domestic firms and industries. One way of getting rid of different product norms is to harmonize them away as the EC attempted to do prior to 1985. The alternative is institutional competition which, however, may exhibit one possible shortcoming. If governments obey domestic interest groups to lower domestic safety standards in order to restore competitiveness of domestic producers, the level of regulation may finally fall below some type of optimum. We have shown above that this problem of zero-regulation is unlikely to arise because the opportunity costs of such a policy are high for any government. Nevertheless, if the market is not fully competitive, a counterbalancing force may be introduced, such as a liability law, e.g the EC Product Liability Directive which became effective in 1985. At the heart of the directive is the principle that the producer of a good will be liable for any damage caused by a defect in this product. Two details are important: (a) that producer is everybody who puts his name, trademark or other distinguishing feature on the product and (b) that a domestic consumer can sue for compensation against all producers in the EC and worldwide (because importers of non-EC goods are legal substitutes for the non-EC producers). Thus, by providing the consumer with a legal instrument, the firms' chances to make profits by supplying ever cheaper goods at ever lower safety standards are reduced significantly. The Liability Directive only introduced a minimum (albeit strict) standard of consumer rights. National governments are still allowed to go further but in that case they face the pressures of institutional competition.

V. CAN GOVERNMENTS COMPETE AFTER MAASTRICHT?

If institutional competition is as advantageous as described above then why is it not Europe's accepted integration strategy? One of the major goals of institutional competition is to break up the deadlocks of markets segmented by national regulations. This leads to fiercer competition which is, understandably, not extended a warm welcome by firms and sectors that prospered under the protection of national regulations. Industrial policy, as government interference with the sectoral structure of an economy is euphemistally called, has been given new momentum through chapter 13 of the Maastricht Treaty. From now on it is an agreed part of the Community's economic policies. In the early days of industrial policy,. ailing industries or sectors were barred from competition either by closing the EC to the rest of the world or paying subsidies to maintain production and jobs. Backed by recent advances in growth and trade theory, the new variety of industrial policy aims at supporting selected industries that promise to produce above average profits, growth rates and (so politicians hope) plenty of new employment opportunities. There are numerous measures that the Community can take to achieve its goals (strategic trade policy, exceptions from competition policy, subsidization of research and development, taking over of exchange rate risks) and quite a few industries that claim to be natural candidates for protection and subsidies.

To examine this type of policy prescription accept for a moment the theoretical reasoning for strategic industrial policy: if significant sunk costs cement monopoly profits, subsidizing research and development may lead to more competition. If learning-by-doing allows for cheaper production, large numbers of products sold and large market shares may act as barriers to market entry. Therefore, financing initial losses of newcomers may actually enhance competition. Since Airbus Industries faced both problems, high sunk costs and significant learning effects, it can serve as a litmus test. Launched with massive subsidies in the 1970's, Airbus broke into the Boeing controlled market for large jet aircraft, now enjoying a market share of 27 percent. Bletschacher, Klodt (1992) view this as a success insofar as it was possible to allow a new producer to enter the market and secure him a sufficient market share. The costs of this policy, however, must also be taken into account. Subsidies amounting to some US-$ 20 billion were handed over to Airbus and even after 20 years in business, the share of subsidies for developing a new Airbus is beyond 70 percent. Therefore it is not coming as a surprise that, according to Klepper (1990), the net welfare effect of Airbus' market entry is negative for Europe, suggesting that the Airbus project actually decreased European welfare. When the market was modelled as basically being a Boeing monopoly the net welfare effect for the world was significantly negative as well. Thus, even in a case where theoretical justitfications for industrial policy are at hand, the practical results are unconvincing. The Airbus example also illustrates that there are other problems typical for industrial policy. The decision on where production plants should be located was dominated by political considerations giving rise to inefficient production schemes und thus operational losses.

There are important theoretical reasons as well for not accepting the recommendations of industrial policy advocates. Organizational problems of ever bigger firms can offset size related cost reductions. It is no wonder that giant firms such as IBM reshape, stressing smaller and sometimes competing units. Conglomerates merged in the seventies are now streamlined. Corporate integration is replaced by strategic alliances that narrowly define the fields of cooperation and stay competitive otherwise. Moreover, the scope of increasing returns to scale is limited by the consumers' preferences for differentiated products. Another counter-argument is the information problem stressed by Hayek. Extensive information is needed in order to select promising industries - a problem known as 'picking the winners'. Governments probably do not possess better information than private firms and - what is even more important - not the same incentive to gather and process it because in case of a failure (due to the lack of information) politicians will not be held fully liable. In general, there are strong arguments against industrial policy as envisaged in the Maastricht Treaty.

Industrial policy is not desirable at the Community level and it is not at the national level. The reasons for not approving of an EC industrial policy are valid for national industrial policies as well. In addition, competing national industrial policies inevitably lead to an inefficient subsidy race. Competition of national industrial policies is inferior to industrial policy at the Community level, which in turn is inferior to no industrial policy at any level. What is needed to avoid industrial policy at all is a mechanism through which every government can commit itself credibly not to pursue an industrial policy. This is of course not a problem specific to the EC but to world markets. As proposed by Hofman, Koop (1991), the GATT could be extended from basically a free trade agreement to a comprehensive competition agreement where each signatory promises not to engage in industrial policy even if that means to forgo potential domestic growth. The returns of the agreement would stem from all other countries also sacrificing their national industrial policies.

The fact that the European car makers will also get handouts from the EC for their research activities illustrates that the EC has taken the protectionist road. In contrast to the aircraft industry, the world market for cars is highly competitive. What weakens competition is not so much the existence of high sunk costs or significant economies of scales but rather heavy subsidization of national producers and protectionism in the form of trade barriers. Here institutional competition and the country-of-origin principle could help to break up market segmentations. Allowing, for instance, German importers of

Japanese cars to sell their imports to French customers would soon put the subsidized firms under enormous pressure to cut costs and produce better cars - and politicians under a lot of pressure to save the national firms and jobs. Here again, Europe is at the crossroads. One direction is to force national producers to adjust to market pressures which could be made easier by governments through improving institutional arrangements. The other would be to annul institutional competition and coordinate national policies, subsidizing firms inside the EC and protect them from outside competition through building the fortress Europe. By pressing Japan to agree on voluntary export restraints and thereby upgrading national protectionism to the European level, the EC has apparently decided in favor of the second way. Now European car makers have to compete with only 1.2 million Japanese imports in an estimated 15 million sales a year market. Even worse, some countries are allowed to maintain national quotas (of as little as five percent in the case of France). The period for which protection will be granted to European car makers is actually limited to the end of this century. Expectations, however, exist that some of them can not appreciably narrow the productivity gap with their Japanese competitors. Therefore it is not unlikely that another protecionist period will be announced.

Moreover, there are signs that other European industries as well feel they are not ready to withstand international competition and that some governments are prepared to protect these industries. The list of sectors thirsting for protection is impressive: electronics, shipbuilding, motor vehicles, steel, and most prominent, agriculture. Impressive too is the damage done. Without a drastic reform of the EC's Common Agricultural Policy (CAP) free trade cannot be perennially preserved. As long as some trading partners blatantly disobey the rules of free trade, the world's trading system faces the risk of returning to bilateralism and regional bloc building. Without a change of the trade policy towards the reforming countries of Eastern Europe, the transformation process there may stall with equally gloomy consequences.

VI. THE SOCIAL DIMENSION

Social policy has never been at the heart of the European integration process. Although even the CAP was partly justified by social security considerations, there are only a few hints in the integration treaties that deal with social problems. The social dimension debate comprises three aspects: redistribution (e.g. welfare programs), social policy (everything from health care and old-age pension schemes to maternity benefits), and labor market regulations (working conditions, systems of wage bargaining and labor representation and participation). As these fields are tightly interconnected and complex we only choose to highlight some of the problems arising in the process of closer EC integration. With respect to redistribution, we have shown that it will get increasingly difficult to redistribute from mobile factors of production to immobile ones.

An interesting question is whether national social policies require harmonization. Ex-ante harmonization would only be justifiable if the outcomes of competitive social policies where either considered unfair or inefficient due to market failure. Paqué (1989) examined various absolute and comparative criteria for fairness but failed to identify even a single one that would call for harmonization. Leaving the fairness issue to philosophers, we rather turn to the possibility that institutional competition in social policies leads to an inefficient allocation of resources. Consider a country that improves its social policies. This can have two effects. On the one hand, it may reduce investment risks and increase profitability through higher labor productivity brought about by fewer sick-leaves and strikes. This in turn could induce an inflow of capital and qualified labor to some extent. On the other hand, more expensive social programs increase effective wages since they are largely financed through wage related payments such as the general income tax or wage dependent social insurance contributions levied on employees and employers. More expensive labor changes factor intensities and the production of labor-intensive goods will be shifted to countries with lower labor costs. If factor mobility is unrestricted, the shift in the international division of labor depends on the magnitudes of the real wage change and the productivity effect of improved social programs. A need to harmonize social policies on the grounds of an inefficient allocation of resources cannot be found. Moreover, social policy can be interpreted as a location factor since it is largely administered according to the territory principle. Analogous to infrastructure or education, competing social policies would simply force governments to adopt efficient social programs.

There are good reasons to organize the various components of the social security system (unemployment, inability, old age pensions) whenever possible as a user-pays-system where benefits are linked to contributions paid as in the German case. In the European case this means that the concept of benefit taxation should be applied analogously to the social security system. More specifically, every person insured should receive the benefits in the area where the contributions were paid (territory principle). Thus, the social security system is not a centralized European one but a set of independent national systems being in institutional competition with each other.

Two objections can be raised to competing social policies. First, it is argued that this integration approach would make the poor EC members poorer. Instead of achieving cohesion, income disparities would deepen which would makes additional intra-Community transfers necessary. However, the inflow of capital will cause labor productivity to increase and consequently wages to rise. Taking into account that the demand for social policies exhibits a high positive income elasticity, social services in the countries with low present per-capita income will improve as well. At least in the long run this counters the second objection to competing social policies, namely the reproach of "social dumping". Social dumping, understood as cutting social policies in the richer countries in order to restore competitiveness, oversees the negative effects that these cuts may have on labor productivity in particular and social stability in general. Only in extended welfare states where governments implemented a generous network of social programs actual cuts may occur. But again, that would be a situation in which the marginal costs of an institutional arrangement would exceed its marginal benefits. Competing social policies could be a device to make corrections necessary and at the same time politically feasible.

Another area where institutional competition can be fruitfully applied are labor market regulations, especially the national systems of wage bargaining. At present, only directives on minimum standards of working conditions and health and safety provisions are ratified or drafted. Harmonization of any substance does not exist. Article 118 of the Maastricht Treaty, however, calls for closer cooperation on labor participation in firms' decision making, legal provisions of labor contracts, and collective wage bargaining. So far, the national systems of wage bargaining differ substantially in the EC. Competition of the systems will prove which one scores best on employment and inflation. Moreover, institutional competition would force governments to check the efficiency of other labor market regulations as well, for instance job security legislation or the monopolies of state-run employment exchanges.

VII. HARMONIZING MONEY

The Maastricht Treaty has put macroeconomics back on the EC's agenda and it has done so by applying the ex-ante harmonization approach. The most exposed single issue is the creation of the European Monetary Union (EMU), the design of a single currency for twelve different nations with twelve heterogeneous sets of preferences regarding price level stability, twelve distinct histories of monetary policies, twelve inflation track records and twelve systems of administering monetary policy.

The risk of creating a weak European currency partly derives from the possibility of merging countries with different attitudes towards monetary stability and different levels of economic development. Therefore, participation in EMU was made dependent on the fulfillment of various convergence criteria: total government debt must be less than 60 percent of GDP and annual budget deficits must be smaller than 3 percent of GDP. The inflation rate may only be 1.5 percentage points above the average inflation rate of the three lowest inflation rates in the EC. Finally, the exchange rate may not have been devalued two years before entering EMU and long term interest rates must broadly be in line with comparable rates in the low inflation countries.

By setting quantitative criteria in advance, the Maastricht Treaty seeks to mitigate the risk of a weak Euro-currency. However, two objections must be raised. First, the quality of some indicators is uncertain. For obvious reasons, the requirement of a low budget deficit in the year before entering EMU should have been extended for a number of consecutive years and it should include stealth budgets. The criterion on indebtedness conveys limited information. It reflects a long history of running up debts and it does not take into account whether the funds were used for consumption or investment. Therefore, the number 60 seems to be chosen arbitrarily. On the contrary, the interest rate and inflation criteria are useful measures because they comprise an element of competition. If, for example, a low inflation country reduces its inflation rate it simultaneously forces high inflation countries to follow suit - a competition for stable money. To enhance this competition, the European Council and the Commission will be constantly assessing the stabilization efforts (and success) of the member countries. In the second half of the decade they will even be allowed to enforce this goal through withholding EC benefits - another safeguard clause for achieving economic stability.

Second, a serious question will be to what extent the criteria will be interpreted in a politically soft way in order to bring countries into EMU that would normally not qualify for membership. For instance, the wish of the EC-founding countries Belgium and Italy to also co-found EMU may generate pressures to soften the interpretation of the convergence criteria. In that case monetary stability would be at risk because a European monetary policy that aims for stable money needs accomodation by sound national fiscal policies.

The main problem for the EMU will be to transfer credibility from the national central banks to their European successor. One important aspect is that the national central banks are independent before a European currency would start. A period of independence of at least two years in which national central banks could build up a reputation of pursuing an independent monetary policy would be helpful. The political decision of some countries to make the central bank independent just the second before the starting signal of monetary union calls the independence of the European Central Bank (ECB) into question and undermines its credibility even before it is founded.

Even if the ECB is legally independent, it may not be in practice. National ECB governors who seek re-appointment after serving a relatively short term may choose to please their national governments by voting for a less stringent monetary policy. The most decisive issue, however, is whether a European monetary policy can be insulated from the moral hazard problem of political pressure. A European monetary policy affects each region of Europe in a uniform way - the same interest rate will be effective from Aberdeen to Heraklion; but the policy making process remains at the national level. This represents a systematic source of conflict, and it is hard to say to what extent a European monetary policy can withstand this conflict. A European Central Bank needs extremely strong safeguards in such a context and it is open whether institutional arrangements with respect to fiscal policy can provide sufficiently strong ones.

Leaving aside such intricate issues as the ECB's independence, the level of transfers needed in a currency union without exchange rates and the willingness of countries to pay the price of transfers in favor of European integration, the central question is whether the EC is an optimum currency area. As Eichengreen (1991) shows, the EC does not fulfill the requirements for an optimum currency area too well, i.e. high factor mobility and no region-specific shocks and disturbances. Possibly, the Internal Market leads to more specialization of regions, due to the fact that firms are increasingly able to exploit economies of scale. This would make European economies even more diverse - not less. As German unification has proven, asymmetric shocks cannot be ruled out. Then, flexible nominal exchange rates are more important than before to adjust to real shocks. The foreign exchange turmoil of mid-September 1992 has lent additional support to this view. Two devalutions and suspension of two currencies from the European Exchange Rate Mechanism (ERM) have shown that the degree of economic convergence is lower than expected.

Although the ERM has, by and large, functioned properly its recent shake-up made it obvious that the system is in need of repair. A solution may consist in allowing competition between the national central banks and the institutional rules defining their behavior such as operating procedures, monetary policy instruments, money targets and the space to manouvre in open market operations. Those banks and currencies could merge of their own free will that have similar institutional arrangements (reflecting similar preferences on stable money), low inflation rates and that represent economies that have converged close enough to make exchange rates unnecessary for internal adjustments. This leaves open how many currencies join and when they do. The "new" central bank could start with the credibility it inherits from its national predecessors that must be truly independent beforehand. Imagine the Netherlands, Germany and Austria forming a currency union, institutionalizing the policies they have pursued for years. The other countries would be left with an adjustment mechanism to absorb real shocks that hit their economies and the central banks would face an incentive to build up their own credibility. This solution, however, calls for a more flexible approach to EC membership than the current "all or none".

VIII. INSTITUTIONAL COMPETITION AND CONSTITUTIONAL STRUCTURE

Monetary policy may be viewed as a field in which transaction costs can be reduced by some type of ex-ante harmonization. Another example are technical standards where voluntary agreement by the affected industries reduces transaction costs. Thus, there are circumstances under which institutional competition does not yield efficient solutions. Especially, problems arising in the EC's external trade policy, international competition policy, and transfrontier problems in environmental policy can only be solved at the European level. In these cases the process of institutional competition has to be supplemented by additional measures.

To determine what measures are appropriate to support institutional competition, the more general question has to be answered which constitutional structure is envisaged for the future of Europe. There is a continuum of possible constitutional structures reaching from a centralized political entity to a loose confederation of independent states. As the referendum in Denmark (and that in France) showed, Europe is not ready for political union. Euroscepticism is largely fed by governments that are moving towards centralization more readily than their electorates approve of and that abuse monetary union as a precursor for political union.

To soothe the voters in Denmark and elsewhere the Council and the Commission introduced the subsidiarity principle and emphasized it at the Birmingham summit. Subsidiarity which delegates all policy matters to the lowest level of government that can cope with them, in principle counteracts centralization forces. However, serious doubts about its effectiveness remain. As has been argued elsewhere (e.g. Sachverständigenrat 1992), it will be very difficult to put the subsidiarity principle into concrete terms, describing what each level of government is allowed to do. The key question is whether subsidiarity will be justiciable or whether it will only survive as a noble principle of political theory bar any practical value. The suspicion that it will not be justiciable derives from the fact that the Maastricht Treaty does not set down specific rights of national governments and citizens that in case of conflict could be used by the European Court as a guideline for decision-making.

To make institutional competition work in practice, Siebert, Koop (1990) proposed a set of rules that governments have to obey. In addition to a European liability law, the rules envisaged also include that countries have to stay open for goods and services, people, and capital with respect to their EC partners. Capital flows and trade with the rest of the world should be unrestricted. Moreover, a truly European competition policy for firms has to protect national governments from the powers of EC-wide monopolies. In the case of trans-border externalities, e.g. environmental pollution, rules for the internalization of externalities have to be included. Obedience to these rules for governments would have to be checked by an independent European body. This is of course a solution that very much favors a compromise between the two extreme constitutional alternatives: centralization where necessary, independence where possible.

IX. DIFFERENT TIERS OF EUROPE

Officially, the Community is still marching in step: every country is sticking to the Community. In practice, the EC is already moving in another direction. Britain opted out of Maastricht's social chapter, the European Monetary Union is limited to countries that fulfill the convergence criteria. The Danes voted "No" on monetary as well as political union, the passport-free zone envisaged in the Schengen Agreement comprises only eight members. Finally, a common defence policy was launched by setting up a joint Franco-German army corps. One variety of institutional competition could be to allow for different degrees of membership.

Tichy (1992) extends the idea of an optimum currency area to an optimum integration area. He finds that for any plausible indicator the EC is too diverse to be an optimum integration area. On the one hand, it comprises only loosely connected countries (Denmark and Portugal) while, on the other hand, it excludes economies (Austria) that are tightly interconnected with EC-economies (Germany). Even worse, for different integration criteria different groupings of countries are optimal. This suggests that there should be different tiers of the European Community with one Treaty for every broadly defined policy matter. This would facilitate the deepening as well as the further enlargement of the Community. Currently Europe shifts towards a system with a core of monetary stability comprising Germany, the Netherlands, and possibly Belgium, Luxembourg, and France. With institutional competition and different tiers of integration, the core could be extended by Austria and possibly Switzerland.

Instititutional competition will allow to keep the EC open. It could be especially helpful in the process of integrating the former communist countries into the EC, especially Poland, Hungary, and whatever is left of Czechoslovakia. It would be particularly adventageous if the EC decided to give up its own protectionist policies towards Eastern Europe. Opening up the EC markets for agricultural products and textiles would tremendously help the Eastern European countries to export goods where they have a comparative advantage, thereby supporting their transformation into market economies. In addition, this may help to avoid mass-migration from East to West and force the Community to reform its outdated CAP. For the transition itself, institutional competition seems to be the appropriate strategy since proper experience on that matter is lacking or limited at best. Exchange rate policies, privatization, macroeconomic stabilization, avoiding social upheaval, and the more general question of sequencing, i.e. gradualism versus shock therapy cannot be answered beforehand and in a way that meets the specific needs of each country. As a matter of fact, the former socialist economies are already engaging in institutional competition with developing countries in the sense that they compete for foreign direct investment. The need to attract foreign capital acts as a strong incentive for governments to keep the transformation process going (and as a pleasant political scapegoat for unpopular reforms).

For this to occur, different tiers of government and different degrees of membership must be allowed. For the first part of this proposal, fiscal federalism and subsidiarity are the catchwords: leave the provision of local public goods to local governments that compete in the Tieboutian sense, leave education to state or federal governments, and assign only all-European tasks such as competition policy or foreign policy and defence to the Community. The second part envisages a more flexible Europe, with the possibility for countries to choose the policy areas where they want to join collective government. All member countries (present and future) would have to acccept a core of rules which defines the EC. For the time being, these rules would have to be economic and could consist, for example, of the EC's Internal Market program. For other policy matters, countries that are willing and suited for further integration can move ahead, without being stopped by countries not willing to integrate. The question, however, whether institutional competition or ex-ante harmonization will be the predominant integration strategy for the 1990's reflects a deeper schism. Among the current EC members the role of states and governments is assessed differently: either as welfare states or as competition states. The public discussion which one is to serve as the model for Europe has just begun. Until this question will have been answered, Europe remains at the crossroads, politically and economically.

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